

REDACTED DIRECT TESTIMONY

OF

JOY NICDAO-CUYUGAN

ACTING DIRECTOR

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

ILLINOIS POWER COMPANY

DOCKET NO. 98-0210

APRIL 1998

1 1. Q. Please state your name and business address.

2  
3 A. My name is Joy Nicdao-Cuyugan. My business address is 527 East Capitol  
4 Avenue, P.O. Box 19280, Springfield, IL 62794-9280.  
5

6 2. Q. What is your current position with the Illinois Commerce Commission?  
7

8 A. I am presently the Acting Director of the Finance Department of the Financial  
9 Analysis Division.  
10

11 3. Q. Please describe your qualifications and background.  
12

13 A. In April of 1987, I received a Bachelor of Science degree in Business Management  
14 and a Bachelor of Arts degree in Psychology from De La Salle University. In May  
15 of 1991, I received a Master of Business Administration degree, with a  
16 concentration in Finance, from the University of Illinois at Springfield. I was  
17 employed by the Illinois Commerce Commission in July 1991 as a Financial  
18 Analyst and was promoted to Senior Financial Analyst in May 1994. In April  
19 1998, I was assigned the responsibilities of Acting Director of the Finance  
20 Department. I have previously testified before the Commission on rate of return  
21 and other regulatory finance issues.

1  
2 4. Q. What is the purpose of your testimony in this proceeding?

3  
4 A. The purpose of my testimony is to present my assessment of whether Illinois  
5 Power Company (IP or the Company) has met the applicable finance-related  
6 requirements in Article XVIII of the Illinois Public Utilities Act (Act).  
7

8 5. Q. Please summarize your findings and recommendation in this proceeding.  
9

10 A. The Company met the applicable finance-related requirements in Article XVIII of  
11 the Act with the exception of one requirement. Specifically, IP did not reasonably  
12 demonstrate that its planned use of proceeds from its proposed issuance of  
13 transitional funding instruments (TFIs) will result in a reduction of its overall cost  
14 of capital, taking into account the costs of financing, as required by Section 18-  
15 103(d)(1)(A). Therefore, I can not recommend approval of the Company's  
16 securitization proposal to issue \$1.728 billion TFIs and use the proceeds to  
17 , as  
18 filed in this proceeding. However, the Company has reasonably demonstrated that  
19 to the extent TFI proceeds will be used to only,  
20 the Company's overall cost of capital will be reduced. Thus, it's my  
21 recommendation that the Commission issue a transitional funding order that

1 authorizes the Company to use the proceeds for purposes of

2 .

3  
4 6. Q. Please summarize the finance-related requirements of the Act that you determined  
5 IP met in this proceeding.

6  
7 A. Based on my review of the Company's petition, Company witnesses Altenbaumer  
8 and Mortland's testimony, IP's 1996 annual report to the Commission (Form 21  
9 ILCC) , the Commission's Order on Rehearing in Illinois Power's last electric rate  
10 case (Docket 91-0147), and the Company's response to JNC-1.19, IP met most of  
11 the finance-related requirements in Article XVIII of the Act that are applicable to  
12 this proceeding. Those finance-related requirements are as follows:

- 13 • The aggregate amount of TFIs to be issued shall not exceed: (a) during  
14 the twelve-month period commencing August 1, 1998, an amount equal  
15 to 25% of the applicable electric utility's total capitalization, including  
16 both debt and equity, as of December 31, 1996, multiplied by the ratio  
17 of the electric utility's revenues from Illinois electric utility retail  
18 customers in the 1996 calendar year to its total electric retail revenues  
19 for such 1996 year; and (b) thereafter, an amount equal to 50% of the  
20 applicable electric utility's total capitalization, including both debt and  
21 equity, as of December 31, 1996 multiplied by the ratio of the electric

1 utility's revenues from Illinois electric utility retail customers in the 1996  
2 calendar year to its total electric retail revenues for such 1996 year.

3 (Sec. 18-103(d)(6))

- 4 • The expected maturity date for the TFIs shall be no later than December  
5 31, 2008, subject to the provisions of subsections (l) and (m) of Section  
6 18-104. (Sec. 18-103(d)(2))
- 7 • The TFIs may not be issued until August 1, 1998, and may not be issued  
8 after December 31, 2004. (Sec. 18-111(1))
- 9 • The electric utility must use at least 80% of TFI proceeds to refinance  
10 debt or equity, or in the event the Commission finds that the sale or  
11 issuance of TFIs for the following purposes is in the public interest, (i)  
12 to repay or retire fuel contracts or obligations related to nuclear spent  
13 fuel previously incurred by the electric utility in providing electric power  
14 or energy services prior to the effective date of the Electric Utility  
15 Transitional Funding Law (EUTFL) or (ii) to pay any expenditures  
16 required to be undertaken by such electric utility by the provisions of  
17 Section 16-128 of this Act including labor severance costs and employee  
18 retraining costs. (Sec. 18-103(d)(1)(B))
- 19 • No more than 20% of the maximum amount of TFI proceeds permitted  
20 can be used to: repay or retire fuel contracts or obligations related to  
21 nuclear spent fuel previously incurred by the electric utility in providing

1 electric power or energy services prior to the effective date of the  
2 EUTFL; pay any expenditures required to be undertaken by such electric  
3 utility by the provisions of Section 16-128 of the Act including labor  
4 severance costs and employee retraining costs; to fund debt service and  
5 other reserves, commercially reasonable costs and fees necessary or  
6 desirable in connection with the marketing of the TFIs; to pay for  
7 commercially reasonable costs associated with the issuance and  
8 collateralization of the TFI; and pay for the commercially reasonable  
9 costs associated with the issuance of such TFIs, including the costs  
10 incurred since the effective date of the EUTFL, or to be incurred, in  
11 connection with transactions to recapitalize, refinance or retire stock  
12 and/or debt, any associated taxes, and the costs incurred or to be  
13 incurred to obtain, collateralize, issue, service and administer TFIs,  
14 including interest and other related fees, costs and charges. (Sec. 18-103  
15 (d)(1)).

- 16 • The electric utility cannot use the proceeds of the sale of TFIs to repay or  
17 retire obligations incurred by any affiliate of the electric utility (other than  
18 in connection with any financing of grantee instruments or TFIs issued by  
19 such affiliate), without the consent of the Commission. (Sec. 18-  
20 103(d)(1))
- 21 • The electric utility's use of such proceeds for the purposes specified in 18-

103(d)(1)(A) shall not, as of the date of application of such proceeds, result in the common equity component of its capital structure, exclusive of the portion of its capital structure that consists of obligations representing TFIs or grantee instruments, being reduced below the lesser of: (a) 40%, and (b) the common equity percentage as of December 31, 1996 adjusted to reflect any write-off of assets or common equity implemented or required to implemented as a result of the EUTFL. (Sec. 18-103(d)(1))

- When proceeds of TFIs are used to refinance debt or equity, any proceeds transferred to a parent company through a common stock repurchase transaction shall be used to retire publicly traded common stock of the parent company or to pay commercially reasonable transaction costs associated with such retirement. (Sec. 18-103(d)(a)(A))
- The aggregate amount of intangible transition property (ITP) to be created does not exceed the sum of (i) the rate base established by the Commission in the electric utility's last rate case prior to the effective date of the EUTFL, plus (ii) any expenditures required to be undertaken by such electric utility by the provisions of Section 16-128 of the Act, including labor severance costs and employee retraining costs, plus (iii) amounts necessary to fund debt service and other reserves, commercially reasonable costs and fees necessary in connection with the marketing of the TFIs, plus (iv) commercially reasonable costs incurred from and

1 after the effective date of the EUTFL or to be incurred which are  
2 associated with the issuance and collateralization of the TFIs, plus (v)  
3 commercially reasonable costs incurred from and after the effective date  
4 of the EUTFL or to be incurred which are associated with issuance of  
5 such TFIs, including the costs incurred from and after the effective date  
6 of the EUTFL, or to be incurred, in connection with transactions to  
7 recapitalize, refinance or retire stock and/or debt, any associated taxes  
8 and the costs incurred to obtain, collateralize, issue, service and/or  
9 administer TFIs, including interest and other related fees, costs and  
10 charges (all of the foregoing costs described in clauses (i) through (v)  
11 above to include any taxes), where applicable, to the extent the costs  
12 thereof would otherwise have been recoverable by an electric utility  
13 through rates for tariffed services under the Act as in effect prior to the  
14 EUTFL, minus (vi) the amount of any ITP previously created and  
15 established at the request of and for the benefit of such electric utility in  
16 a prior transitional funding order. (Sec. 18-104(a))

17  
18 7. Q. What finance-related requirement in the Act did IP fail to meet in this proceeding?

19  
20 A. Sec. 18-103(d)(1)(A) of the Act states in part that an electric utility can use the  
21 proceeds from the sale and issuance of TFIs for the following purpose: to



refinance debt or equity, or both, *in a manner which the electric utility reasonably demonstrates will result in an overall reduction in its cost of capital*, taking into account the costs of financing. (Emphasis added.) The Company indicated that it will use the proceeds from the planned TFI issuance “to \_\_\_\_\_, plus pay for allowable issuance and redemption costs related to the TFI and the refinancings and set up the cash reserve associated with the issuance of the TFI.” (IP Ex. 1.1, pp. 4-5) However, the Company did not reasonably demonstrate that the proposed TFI issuance and planned use of proceeds will result in an overall reduction in its cost of capital.

8. Q. The Company attempted to demonstrate that its use of the TFI proceeds will reduce its cost of capital through the testimony of its witnesses, Mr. Mortland and Mr. Witt. Please explain why Mr. Mortland's testimony did not "reasonably demonstrate" that the proposed TFI issuance and planned use of proceeds will result in an overall reduction of IP's cost of capital.

A. Mr. Mortland claimed that because debt is less expensive than equity and because the TFI's are expected to have a lower interest rate than the cost of capital from the TFI proceeds, IP's overall capital costs will be reduced. (IP Ex. 2.1, p. 11) To illustrate this claim, Mr.

1 Mortland calculated IP's weighted average cost of capital with and without  
2 issuance of TFIs using the assumption that the cost of common equity does not  
3 change regardless of the change in the composition of IP's capital structure and  
4 whether or not TFIs are issued. (IP Ex. 2.4) However, Mr. Mortland's  
5 reasoning and quantitative illustrations are both flawed and misleading.

6  
7 Mr. Mortland's reasoning ignores modern capital structure theory which  
8 recognizes that in spite of debt's tax-advantages and lower cost compared to  
9 common equity, increasing debt in the capital structure can increase a firm's  
10 overall cost of capital.<sup>1</sup> Employing debt as a source of capital reduces a company's  
11 income taxes, thereby reducing its cost of capital; however, as reliance on debt as a  
12 source of capital increases, so does the probability of financial distress (e.g.,  
13 bankruptcy). As financial distress becomes more probable, expected payments to  
14 attorneys, trustees, accountants and other parties increase while the expected value  
15 of the income tax shield debt financing provides declines. Consequently, beyond a  
16 certain point, an increasing dependence on debt as a source of funds will increase  
17 the overall cost of capital. Therefore, it is incorrect for Mr. Mortland to claim that  
18 IP's cost of capital will be reduced simply by introducing more debt into its capital  
19 structure.

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<sup>1</sup> Brigham, E. and Gapenski, L., *Financial Management: Theory and Practice*, 8<sup>th</sup> ed., pp. 646-648.

1 Moreover, Mr. Mortland's calculations of IP's overall cost of capital with and  
2 without the issuance of the TFIs are based on a flawed and unsupported  
3 assumption. Mr. Mortland's calculations assume that the Company's cost of  
4 common equity remains constant whether the common equity ratio is as high as  
5 % or as low as %. (See IP Ex. 2.4) This, once again, is at odds with  
6 modern capital structure theory which recognizes that capital costs change as more  
7 or less debt is used in a firm's capital structure.<sup>2</sup>

8  
9 9. Q. Mr. Mortland believes "that if Illinois Power were not able to proceed with  
10 securitization, then the cost of common stock equity would increase, as compared  
11 to what it would be with securitization." (IP Ex. 2.1, p. 12) Please comment.  
12

13 A. Mr. Mortland's statement is problematic because he did not provide any support  
14 for his belief. In response to Staff's data request JNC-1.13, Mr. Mortland  
15 indicated that his belief is not founded on any quantitative analysis but only on  
16 discussions with financial advisers and analysts. In my opinion, this does not  
17 constitute a reasonable demonstration that the Company's cost of common equity  
18 would not increase if it proceeded with its securitization proposal as filed.  
19

20 Nonetheless, Mr. Mortland's calculations of IP's overall cost of capital with and

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<sup>2</sup> Ibid.

1 without the issuance of the TFIs assumes the same cost of common equity for both  
2 scenarios. (See IP Ex. 2.4) Mr. Mortland claimed to use this assumption to show  
3 that capital costs decline even without accounting for a change in the cost of  
4 common equity. (IP Ex. 2.1, pp. 12-13) This rationale is an underlying problem  
5 of his analysis. A valid assessment of a firm's cost of capital must include changes  
6 in the cost of common equity. As explained earlier, the proportions of debt and  
7 equity in a capital structure affect the cost of each capital component, thereby  
8 affecting the overall cost of capital. In effect, Mr. Mortland's analysis is simply a  
9 mathematical exercise that provides no useful information about the changes in  
10 IP's overall cost of capital with or without its securitization proposal.

11  
12 10. Q. Does Company witness Mr. Witt's testimony "reasonably demonstrate" that the  
13 Company's proposed securitization would result in a reduction of its overall cost  
14 of capital?

15  
16 A. No, it does not. Mr. Witt's testimony makes an assertion similar to Mr. Mortland,  
17 that is, IP's overall cost of capital will be reduced to the extent that the proceeds  
18 from the TFI issuances are used to retire existing securities with higher cost. As a  
19 general proposition, a one-for-one replacement of existing debt with lower cost  
20 debt would result in a decline in the overall cost of capital. However, IP's  
21 proposed securitization

(i.e., TFIs). As shown in IP Ex. 2.4, since from TFI proceeds, the net result from the proposed securitization is an increase in the Company's ratio from % in December 1997 to % in December 1999. As indicated in my earlier discussion on modern capital structure theory, this large increase in may cause an increase in IP's overall cost of capital. Therefore, Mr. Witt cannot conclude that the replacement of IP's higher cost securities with lower cost TFIs will necessarily result in a decrease in IP's overall cost of capital without the support of a valid analysis.

11. Q. What would be present in a reasonable demonstration that the planned use of proceeds from a proposed TFI issuance will result in a reduction of a firm's overall cost of capital?

A. As my earlier discussion of modern capital structure theory indicates, the issuance of TFIs and the with the proceeds from such an issuance has two opposing impacts on a company's cost of capital. Replacing higher cost securities with less costly securities would tend to reduce the overall cost of capital, all other things held constant. On the other hand, increasing the proportion of fixed financial obligations in the capital structure by would tend to increase the overall cost of capital, all other things

1 held constant. A reasonable demonstration of a reduction in the overall cost of  
2 capital necessarily involves a comprehensive analysis of these two opposing  
3 impacts on IP's cost of capital. Unfortunately, the Company's testimony only  
4 addresses one aspect of this analysis, that is, how replacement of higher cost debt  
5 with lower cost debt (TFIs) can lower the Company's overall cost of capital. A  
6 reasonable demonstration must also address the impact of changes in capital  
7 structure on the overall cost of capital. Specifically, the Company must perform an  
8 analysis and present evidence that demonstrates increasing its  
9 , as a result of its securitization proposal, will not cause a net  
10 increase in its overall cost of capital (i.e., the increase in cost of capital resulting  
11 from additional in the capital structure does not exceed the decrease in the cost  
12 of capital resulting from the use of lower cost capital).

13  
14 12. Q. In its revised response to Staff data request JNC-5, the Company provided a  
15 calculation of IP's free cash flow per share with and without its securitization  
16 proposal. Does that data request response reasonably demonstrate that the  
17 Company's cost of equity would decline as a result of its securitization proposal?  
18

19 A. No, it does not. The Company's response provided a calculation of IP's projected  
20 free cash flow per share from 1998-2008 under three different scenarios: a) a TFI  
21 interest rate of 7.50%; b) a TFI interest rate of 6.00%; and c)

1 with TFI proceeds, TFI interest rate of  
2 6.00%. Under each scenario, the projected average annual cash flow per share  
3 under the assumption that IP proceeds with the securitization proposal is lower  
4 than the projected average annual cash flow per share under the assumption that IP  
5 does not proceed with its securitization proposal.<sup>3</sup> In its response to Staff data  
6 request JNC-5, the Company states that the free cash flow per share analysis did  
7 not demonstrate conclusively whether IP's cost of equity would increase or  
8 decrease with securitization. I agree with the Company's conclusion. Although  
9 the analysis indicates lower free cash flow under securitization than without, the  
10 analysis does not address the volatility of IP's cash flows since the analysis is  
11 largely based on assumed trend lines. It is the volatility or variability in the  
12 Company's free cash flows that is essential in analyzing risk. Therefore, the  
13 response to Staff data request JNC-5 does not constitute a reasonable  
14 demonstration that IP's cost of common equity would not increase under its  
15 securitization proposal.

16  
17 13. Q. If the proceeds from the TFI issuances were used to retire only outstanding long-  
18 term debt, what would be a reasonable demonstration of a reduction of the  
19 Company's overall cost of capital?

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<sup>3</sup> The average annual difference between cash flow per share with securitization and without securitization (with securitization cash flow minus without securitization cash flow) from 1998-2008 for scenarios a, b, and c are \$ , \$ and \$ , respectively. Source: Company response to Staff data request JNC-5.

1  
2 A. Since this hypothetical scenario does not contemplate a change in the Company's  
3 capital structure, a demonstration that the new debt would be less expensive than  
4 the existing debt would be sufficient. In that situation, a one-for-one replacement  
5 of higher cost outstanding debt with lower cost debt can be reasonably expected to  
6 result in a decline in the Company's overall cost of capital.  
7

8 14. Q. Did the Company reasonably demonstrate that the new, lower cost debt (TFIs)  
9 would be ?  
10

11 A. Yes, it did. Mr. Mortland's testimony indicates that based on an analysis of the last  
12 securitization issuance in 1997 in California and the yield on five-year U.S.  
13 Treasury securities, an interest rate of 5.90% is indicated for the Company's TFIs;  
14 however, he assumed a TFI interest rate of 7.5%. (IP Ex. 2.1, pp. 13-14) As  
15 shown on IP Ex. 2.5, the Company plans to  
16 .  
17

18 15. Q. The Company's petition includes a request that the Commission grant a waiver of  
19 the free cash flow test imposed on IP by the Order in Docket 94-0518 for its stock  
20 repurchases. Please comment.  
21



1           A.     Article XVIII of the Act explicitly allows the repurchase of common stock from  
2                   the proceeds of TFI issuances subject to specific constraints. The Company's  
3                   petition in this proceeding involves the repurchase of its common stock from its  
4                   parent company, Illinova, from the proceeds of its proposed TFI issuance. Based  
5                   on the above information, it appears that the free cash flow test is not necessary for  
6                   IP in this proceeding.

7  
8       16.    Q.     Does this question conclude your direct testimony?

9  
10       A.     Yes, it does.